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IN THE

Supreme Court of the United States

October Term, 1956.

No. 316

CHARLES B. SMITH, as Special Administrator of the Estate of EDWARD S. BIRN, Deceased,

Petitioner,

vs.

MILTON SPERLING, HARRY M. WARNER, JACK L. WARNER, UNITED STATES PICTURES, INC., and WARNER BROS. PICTURES, INC.,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Brief for Respondents, Warner Bros. Pictures, Inc., Harry M. Warner and Jack L. Warner.

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Question Presented.

We believe the case presents only one question and that is:

(1) When facts are found after a full trial upon the issue of jurisdiction, during which each side presented all evidence relevant to that issue, and the facts found establish that the acts of the corporation were in good faith, without fraud, and there is and was no control or domina-

tion at any time of the Board of Directors of the corporation or wrongful participation by any director or officer in the making of a contract, and where it is also found that the corporation was not in the hands of anyone antagonistic to its interests, should the dismissal of the action for lack of jurisdiction, after realigning the corporation as a plaintiff, be reversed?

Statement of the Case.

This is a derivative suit brought by a citizen of New York as a stockholder against his corporation, Warner Bros. Pictures, Inc., a Delaware corporation (Warner); two officers thereof, each a citizen of California; United States Pictures, Inc., a Delaware corporation (United); and a shareholder of the latter, a citizen of California. The complaint alleged that two officers of Warner, Harry M. and Jack L. Warner, together with their brother Albert, owned a controlling block of the capital stock of Warner and controlled and dominated the corporation and its Board of Directors [R. p. 5]; that the individual defendants had illegally and wrongfully conspired to divert the assets of Warner and enrich United and Sperling, a son-in-law of H. M. Warner [R. p. 5], through the making of a contract between Warner and United for the production of motion pictures by United to be partly or wholly financed, distributed and exhibited by Warner [R. p. 6], which constituted waste and diversion of assets [R. pp. 8-9] and was a wrongful gift to United at the expense of Warner [R. pp. 9-10]; that plaintiff had made no demand upon the directors because all or a majority had wrongfully participated in the acts complained of and such board was controlled by the active wrongdoers [R. p. 11].

Warner and its two officials answered, denying all allegations of control, conspiracy and wrongful participation [R. pp. 21-22], and asserting the bar of the Statutes of Limitations [R. p. 25] as did United and its stockholder [R. p. 16 *et seq.*]. When the case came on for trial, the court, deeming that the pleadings raised the question of jurisdiction; ordered that issue to be tried first, together with the issue of the application of Statutes of Limitation [R. p. 72]. The matter of limitation was not reached by the trial court and will not hereafter be mentioned. After such trial, in which the parties offered all evidence deemed material and which the trial court noted was practically coextensive with the merits (117 Fed. Supp. 781 at 804), the trial court made Findings of Fact [Finding IV, R. pp. 74-75] to the effect that the contract had been made in good faith and without fraud, was intended by the Board of Directors to be a financial benefit to Warner, was considered by the Board of Directors to be a sound business arrangement for the best interests of the corporation, and that the officers and the Board acted in good faith and exercised their independent business judgment. It found that the brothers Warner owned less than 20%[1] of the outstanding stock and that neither the corporation nor the directors or officers at that or any other time were under the domination or control of the brothers Warner, and that neither the stockholders, its officers or directors were at any time antagonistic to the financial interests of Warner. It found [Finding V, R. p. 76] that it was not true that all or a majority or any of the Board and officers of Warner had wrongfully participated in the acts complained of, and it

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[1]Actually about 15%—See Stipulation of Facts [R. p. 28].

was not true that said Board was dominated or controlled by any of the individuals. It found that it was not true that if plaintiff had made a demand for redress to Warner that those to whom the application would be made would have been disqualified from faithfully doing their duty, and further, that there was no domination or control of the stockholders of Warner, nor was the corporation at any time in hands or under control antagonistic to its financial interests.

The record was examined by the Court of Appeals herein and the findings of fact were approved [Opin., R. p. 669; 237 F. 2d 317 at 320], the findings being set forth in full in the opinion of that court [R. pp. 666-669; 237 F. 2d 317 at pp. 318-320].

On the basis of these facts, the trial court concluded that Warner should be realigned as a party plaintiff, that then diversity no longer existed and the court was without jurisdiction [R. pp. 79-81]. The Court of Appeals affirmed this result [R. pp. 665-671; 237 F. 2d 321-322].

Petitioner's statement herein, in addition to mingling his own inferences with fact, includes matter (Pet. Br. pp. 6-12) apparently presented to demonstrate that the findings of the trial court herein were not supported by the evidence. This was an argument which was made by petitioner to the Court of Appeals herein and was rejected by it [Opin., R. p. 669; 237 F. 2d 320]. Any question concerning the propriety of the findings would be beyond the scope of the petition herein (*Cf.* Sup. Ct. Rule 40.1 (d)(2)). Furthermore, this court has often said that it will not ordinarily review a conflict of evidence or assess the weight or preponderance thereof (see *N. L. R. B. v. Pittsburgh Steamship Co.*, 340 U. S. 498 at 503, 95 L. Ed. 497 at 482), and the inference advanced by petitioner

in this respect would at most create such a conflict with the preponderance of evidence in the record.[2]

The contract of which petitioner complains was made in 1945 and provides for the production by United of 6

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[2]Supporting evidence in the record included the following: The Warner Board consisted of 11 members [R. pp. 27 and 74], including one vacancy filled in November, 1945 [R. p. 27]. Neither Harry M. Warner nor J. L. Warner attended or participated in the meeting of September 25, 1945 at which the contract was proposed [R. p. 602] or that of September 28, 1945 at which it was approved [R. pp. 605-606]. Directors Friedman and Schneider testified in person [R. pp. 443 and 507], all others testified by deposition. Catchings had no connection with Warner, except as a director [R. pp. 245-246]. He had voted for the contract independently and considered it good [R. pp. 247, 248, 249, 254 and 257]. The brothers Warner did not dictate [R. p. 261] or attempt to force candidates on the Board [R. pp. 262-263]. He had confidence in the recommendations of the executives [R. p. 268]. Guggenheimer, a lawyer, used his independent judgment [R. p. 273] and no one had stated directly or indirectly how he should vote [R. pp. 275-276] or made suggestions or requests [R. p. 278]. He represented a large number of shares of clients [R. p. 284]. Wolf, a lawyer, had not had any suggestions or instructions from anyone how to vote [R. pp. 287-290]. Schneider testified the making of contracts for independent productions was beneficial [R. pp. 522-523] and advancing money or financing pictures was the regular business of Warner [R. p. 554]. The other directors each testified his action, as a director in connection with the United contract, was quite independent, was in the exercise of his best judgment, and no directions or requests of any kind had been given as to such vote or what attitude should be taken [See Carlisle, R. pp. 177, 182, 187 and 188; Perkins, R. pp. 297, 298, 300 and 304; Albert Warner, R. pp. 237, 239 and 240]. Carlisle testified a distribution fee of 20% was profitable [R. pp. 194-195]. Friedman, prior to the meetings, had made a complete written analysis of the contract [R. p. 446] and made a full presentation to the Board [R. pp. 453-454]. Friedman did not consider the brothers had either actual or working control [R. pp. 490-491]. The brothers had influence because they had been executive officers of Warner from its inception and had done well for the corporation through a long period of time and through serious troubles [R. pp. 491-492]. Others than directors testified. The highlights of the contract had been negotiated with Bernhard [Freston, R. p. 391]. The details were negotiated with the attorney for United at arm's length [R. pp. 394-395]. Much of it was based upon a similar independent production contract with Michael Curtiz Productions. [R. p. 409, *et seq.*]

motion pictures to be partly financed and exclusively distributed by Warner [R. pp. 607-647]. Fifty per cent (50%) of such financing was to be furnished by United and the remaining 50% by Warner [R. p. 610]. As distributor of such pictures, Warner was to receive 20% of the gross receipts domestically and 25% for certain foreign distribution [R. p. 617], and after the prior deduction from the gross receipts of the distribution fees and the costs and expenses of production, the net proceeds are divisible equally between Warner and United as received [R. p. 626].

The contract was amended in 1947, 1950 and 1952 to provide for additional photoplays, as to which additional pictures, financing would be furnished 100% by Warner, but on which the distribution fee to Warner was increased to 25% domestic and 30% foreign with division of the net increased to 80% to Warner and decreased to 20% to United [R. pp. 654-655].

It is this contract and its amendments which the plaintiff alleged had been made as a result of the control of Warner by the brothers Warner and to be for the benefit of United and Sperling at the expense of Warner. In 1945, the stock of United had been owned equally by the defendant Sperling, a son-in-law of Harry M. Warner, and Joseph Bernhard, a former officer of Warner [Stip. R. p. 28]. The stock of Bernhard was acquired by Sperling for his family in 1946. At the time of trial, 8 pictures had been made by United under the agreement and even though some had not yet run their normal course

[R. p. 553], all but one had been profitable [Chart, R. p. 660]. The testimony showed that the operations under the contract would show a net profit to Warner of many million dollars, including its receipts for distribution charges [R. pp. 528-529], in addition to indirect benefits. The financial benefits to Warner from the United productions as compared with those of other independent producers whose pictures were distributed by Warner were excellent [Chart, R. p. 659].

The evidence above indicated shows that the contract, its terms, and its operations were in the normal line of business, were not abnormal in nature and could not constitute a grievance nor involve any question of legality unless, as alleged by petitioner, it had been forced upon Warner by virtue of improper control and domination by the individual brothers Warner. At the close of the trial, counsel for these defendants did not admit that Warner was opposing the plaintiff over the legality of the relationship, as petitioner states (Br. p. 11), but did state that the directors would not have brought the suit because they believed the contract was good and advantageous to Warner [R. p. 588].

Summary of Argument.

This is a derivative action in which jurisdiction of the Federal Court depends upon diversity. Jurisdiction must be determined by the court upon the facts. Dependent upon the nature and stage of the proceedings, the determination may be made solely on the allegations of the complaint, or upon the actual facts established by affi-

davits, testimony or other evidence in addition to the pleadings. The facts here on the jurisdictional issue were determined after trial which included stipulations of fact and the introduction of testimony, depositions and records, and facts so obtained are the best and only final basis upon which to test jurisdiction.

Upon these facts, it was the right and duty of the court to arrange the parties accordingly, irrespective of the formal arrangement of parties made in the pleadings. On the facts, the District Court aligned the corporation with the plaintiff who purports to be enforcing the rights of that corporation, and the Court of Appeals affirmed that alignment.

In determining federal diversity jurisdiction, the parties are to be aligned in their true position with respect to the controversy. Rule and decision generally require that any action be brought by the real party in interest and this rule is relevant to determining the position of a party for diversity purposes.

Certain exceptions are allowed to the rule that the action be brought by the real party in interest, but these consist of instances in which the real party in interest is under disability imposed by law or in fact and is hence prevented from proceeding in its own name and in its own interest. Equity, and specifically Rule 23(b) F. R. C. P., permits a derivative suit in the name of a shareholder upon a corporate claim when the corporation refuses or fails to act, but this in itself does not involve federal jurisdiction.

With respect to diversity derivative cases, the decisions of this court establish a special application of the rule of alignment and of the party in interest rule and consider that the corporation occupies a position with respect to the controversy dependent upon the existence or nonexistence of disability to act for itself, thereby meeting the requirements of both general rules.

Such disability is recognized by the decisions of this court as consisting of the domination and control of the actions of the corporation by such persons and to such an extent that the will of the corporation is, in effect, supplanted by that of the individuals exercising such control and the corporation is made to act in a way antagonistic to its own interests.

Here, the facts determined after trial show that there was no domination or control, fraud or other impropriety of the sort, and the allegations of the plaintiff to the contrary were found to be untrue. The business discretion rule is the substantive law of California and does not permit a derivative suit under such circumstances. Denial of allegations of control and domination, or of the existence of disability does not put the corporation in antagonistic hands.

The corporation, being under no recognized disability, should here, as the real party in interest, be aligned with the plaintiff and dismissal for lack of jurisdiction was proper.

ARGUMENT.

The decisions and the principles they establish relating to the alignment of parties in diversity derivative actions have been meticulously and exhaustively set forth in the opinion of the District Court herein (117 Fed. Supp. 781 at 812) and discussed by the Court of Appeals [R. pp. 665-671; 237 Fed. 2d 320-321]. The present case differs from most other reported cases in that here the issue of jurisdiction was formally tried, and findings based on an extensive record were made completely negativing the element of domination or control by any of the persons concerned and establishing positively that the Board of Directors of the corporation had authorized the contract herein in the exercise of its best and independent business judgment. This case, therefore, presents very sharply the question of what the true rule of alignment may be and what are its critical elements. In the interest of brevity, we shall not here repeat the scholarly study set forth in the opinion of the District Court, but we earnestly refer this court to that opinion, though the basis and logic of what we deem to be the rule and the decisions of this court establishing and applying that rule will be here presented.

I.

A Federal Court in a Diversity Case (a) Must Determine the Facts Relating to Jurisdiction, (b) May Do so Separately From and in Advance of Any Other Issue, and (c) May Then on the Facts Align the Parties Irrespective of the Formal Arrangement Made in the Pleadings.

(a) Whenever the jurisdiction of a Federal Court appears in issue, its existence must be determined, and the burden is on the party claiming jurisdiction to show that it clearly exists.

McNutt v. Gen. Motors Acc. Corp., 298 U. S. 178, 80 L. Ed. 1135;

KVOS v. Associated Press, 299 U. S. 269, 81 L. Ed. 183.

(b) Rule 42(b) of the Federal Rules of Civil Procedure contemplates and permits a separate trial of any issue. Such separate consideration has been accepted as proper by this court with respect to the jurisdictional factors in diversity cases.

See

Gilbert v. David (1925), 235 U. S. 561, 59 L. Ed. 360, as to citizenship; and

North Pacific S.S. Co. v. Soley (1921), 257 U. S. 216, 66 L. Ed. 203;

McNutt v. Gen. Motors Acc. Corp. (1935), 298 U. S. 178, 80 L. Ed. 1135;

KVOS v. Associated Press (1936), 299 U. S. 269, 81 L. Ed. 183, as to the amount in controversy.

(c) Following the Act of March 3, 1875, 18 Statutes at Large 470, this court recognized and established the rule of alignment in the *Removal Cases* (1879), 100 U. S. 457, 25 L. Ed. 593, and applied the same rule to actions originally commenced in the Federal Courts in *Pacific Railroad Co. v. Ketchem,* 101 U. S. 289, 25 L. Ed. 932. This court there held that, without regard to the position the parties occupied in the pleadings, for the purpose of determining jurisdiction the court should ascertain the real matter in dispute and arrange the parties properly on one side or the other with respect thereto. Such examination and alignment has since been made and approved many times and over a long period of time.

City of Indianapolis v. Chase National Bank (1941), 314 U. S. 63, 86 L. Ed. 48;

City of Dawson v. Columbia Ave. Savings Fund (1905), 197 U. S. 178, 49 L. Ed. 713.

II.

Both Reason and the Decisions of This Court Require Alignment for Jurisdictional Purposes of the Corporation With the Complaining Stockholder Unless, as a Fact, the Corporation Is so Dominated and Controlled That It Is Under Disability to Protect or Secure Its Own Interests.

(a) The General Rule in a Derivative Action Requires the Alignment of the Corporation With the Complaining Stockholder, Except When the Corporation is in Antagonistic Hands.

Rule 17(a) of Federal Rules of Civil Procedure provides that every action shall be prosecuted in the name of the real party in interest, with certain exceptions. A stockholder's derivative action is not included as an express exception. The cause of action in a derivative suit is that of the corporation itself. The recovery, if any, goes to the corporation. The jurisdictional amount is measured by the corporate claim and not by that of the individual plaintiff. This court outlines the situation in *Koster v. (American) Lumbermens Mutual Casualty Co.*, 330 U. S. 518, 91 L. Ed. 1067, at 522-523, when it says:

> "The cause of action which such a plaintiff brings before the court is not his own but the corporation's. It is the real party in interest and he is allowed to act in protection of its interest somewhat as a 'next friend' might do for an individual, because it is disabled from protecting itself. If, however, such a case as this were treated as other actions, the federal court would realign the parties for jurisdictional purposes according to their real interests. In this case, which is typical of many, this would put Lumbermens on the plaintiff's side. Illinois corporations would

> then appear among plaintiffs and among defendants, and jurisdiction would be ousted. *Indianapolis vs. Chase Nat. Bank,* 314 U. S. 63. But jurisdiction is saved in this class of cases by a special dispensation because the corporation is in antagonistic hands. *Doctor vs. Harrington,* 196 U. S. 579."

Petitioner contends (Pet. Br. p. 14) that in a number of early cases, including *Doctor v. Harrington* (1905), 196 U. S. 579, 49 L. Ed. 606, this court rejected the argument that because the corporation would benefit if the complaining stockholder succeeds, it should be considered as a plaintiff. In *Koster,* as is evident from the above quotation, this court cited *Doctor* not as a rejection of the abbreviated argument described by petitioner but as authority for declining to make realignment of the corporation when that corporation was in antagonistic hands.

(b) The Antagonism Justifying the Exception Is Antagonism to the True Interests of the Corporation.

Antagonistic or hostile hands are terms used in a number of cases. This could mean antagonism to the bringing or maintenance of the particular suit, or antagonism to the true interests of the corporation. Petitioner assumes that antagonism of the first category is alone contemplated by the cases in determining realignment. However, it is apparent that a declination on the part of the corporation to bring the suit is an inherent factor in any derivative action. Absent refusal or failure on the part of the corporation, there would be no suit by a stockholder and yet a refusal or failure, irrespective of its reasons, would be counted by the petitioner as establishing the necessary hostility for jurisdictional purposes.

In so doing, we believe petitioner misuses the elements which determine alignment for federal jurisdictional purposes in that class of diversity cases represented by a derivative suit, with the elements which are requisite in any court of equity as a condition of recognizing plaintiff's right to prosecute a claim of his corporation. On petitioner's theory, every derivative action in which diversity is arranged by the plaintiff and in which there is procedural compliance with Rule 23(b) F. R. C. P., could be brought or would remain in the Federal Court. The comment of the trial judge in this case is very pertinent when he said in his opinion (117 Fed. Supp. at p. 802):

> "Patently, if difference of opinion were all the 'controversy' required to be shown between the stockholder and his corporation in order to preclude alignment of the latter with the plaintiff-stockholder, then there can be no occasion for all the pages of discussion of corporate domination or control, since every stockholder's derivative suit is by definition predicated upon the assumption that the corporation has refused to sue."

It is true, as petitioner states, that this court declined to approve realignment of the corporation in *New Jersey v. Mills* (1884), 113 U. S. 249, 28 L. Ed. 949; in *Railroad v. Grayson* (1886), 119 U. S. 240, 30 L. Ed. 382; in *Doctor v. Harrington* (1905), 196 U. S. 579, 49 L. Ed. 606, and in *Venner v. Great Northern Railway Co.* (1908), 209 U. S. 24, 52 L. Ed. 666. In each of these cases the facts as they stood before the court were diametrically opposite to those found to be true in the present case. *Doctor* and *Venner* were each on the pleadings where the facts consisted of the allegations and, in each

of those, the essential allegations asserted the complete domination and control of the corporation, its Board and its stockholders by the person or persons who are asserted to have done the wrong and reaped the benefit. No other factual matter is emphasized. In *New Jersey v. Mills* and *Railroad v. Grayson*, the terms "domination and control" were not used, but in each the fact was present. In *New Jersey* it was alleged that application to the corporation for redress would have been futile because the individuals concerned were actively engaged in the wrong, and the conclusion of futility could not have been accepted by this court unless the individuals concerned did control the corporation. In *Railroad v. Grayson*, it was noted that, in the allegations of the bill, a majority of the stockholders of the corporation had combined with the other corporation involved in the wrong so that, while no individuals appeared to be so charged, the control did exist and was employed to sacrifice the interests of the corporation. In neither case was there discussion of the fact of control, but it was noted, and discussion was not required because in each the actual grievance alleged was an *ultra vires* act of the corporation, thereby giving rise to a real complaint by a stockholder against his own corporation. Both cases followed very shortly after the *Removal Cases* and may be considered to be in the formative stages of the rule. Petitioner states (Pet. Br. p. 15) that there is nothing in either case to suggest that the managements of the corporations were controlled or dominated; but clearly each did present an instance of domination and control.

Petitioner likewise cites *Delaware & Hudson Co. v. Albany & Susquehanna Railroad*, 213 U. S. 435, 53 L. Ed. 862, as a contrary holding. That case came up on the

facts after trial and was certified upon the single question put by the Court of Appeals as to whether the bill could be maintained for failure to comply with Equity Rule 94, the Court of Appeals stating that the question had been held to be jurisdictional under *Doctor v. Harrington*. In *Delaware* the certified facts showed that the directorates of the two corporations involved were interlocking in that a majority of the Board of Susquehanna were also officers, directors or employees of Delaware. This court did not discuss the question of realignment in any way and we submit that the obvious reason lies in the complete domination of the corporation by the same persons who were the officers and directors of the other corporation. It does discuss *Doctor*, quoting therefrom the allegation of control and domination and holds that in *Doctor*, though there had been no literal compliance with Rule 94, the facts showed the equivalent and excused the necessity for alleging the particulars of a demand under that rule.

In all of these cases, there was then, as a fact, the existence of domination and control and the emphasis in *Doctor* and *Venner* is on that fact alone. The cases do illustrate, however, the necessity for keeping in mind the sharp distinction between the jurisdictional and the merely equitable factors. Domination and control may be, and often is, common to both factors, and this is so in the present case. Plaintiff alleged it to be the reason and excuse why he had made no demand [Compl. par. 24, R. p. 11]. In this instance, the allegation, though found to be untrue, was made to comply with the equitable requirements now established in Rule 23(b) F. R. C. P. The plaintiff also alleged essentially the same matter as part of his cause of action, that is to say, the reason why the contract here involved was wrongful. [*Cf.* Compl. par. 10, R. pp. 6-23, R. p. 10]. Nevertheless, petitioner asserts

(Pet. Br. p. 17) that the sole function of the court in a diversity case is to determine the true matter in controversy, ascertain on which side of that controversy each party really is, and align them accordingly. This is, we believe, the situation in diversity cases as a general class but, as respects derivative actions, this could represent the whole rule only if basic language in the derivative case decisions is completely disregarded. In *Doctor*, the court described the situation as:

> "The ultimate interest of the corporation made defendant may be the same as that of the stockholder made plaintiff; but the corporation may be under a control antagonistic to him, and made to act in a way detrimental to his rights. In other words, his interests and the interests of the corporation may be made subservient to some illegal purpose."

In applying that description in that case, only the fact of domination and control of *Harrington* is stated and repeated, and it appears that domination and control was clearly the factor by which the corporation was made to act in a certain way for an illegal purpose and against the corporate interests. The decision in *Venner*, following *Doctor* by only three years, in considering only the jurisdictional question, again repeats this language from *Doctor*, both as to the description of the circumstance and the fact which caused the corporation to be made to act in such a way. In *Koster, Doctor v. Harrington* is cited as establishing the special case when "the corporation is in antagonistic hands."

In cases such as *Delaware & Hudson Co. v. Albany & Susquehanna Railroad*, 213 U. S. 435 (Pet. Br. p. 16) and *Chicago v. Mills*, 204 U. S. 321, there was no problem of alignment but only of the requirements of equity, and in equity, as is evident from Rule 23(b) F. R. C. P.,

a derivative suit may be permitted, when a corporate cause of action exists, if there is refusal or failure on the part of the directors to afford redress. Under federal equity principles, at least at that time, suit was submitted irrespective of the reasons for refusal, or whether or not such refusal or failure was attributable to a sinister attitude. Such conclusion is not necessarily true under state law, but the cited cases preceded *Erie v. Tompkins* (1937), 304 U. S. 64; 82 L. Ed. 1188, and apparently did not take any possible impact of state law into consideration. But in the derivative cases where alignment has been discussed and jurisdiction considered, the decisions include the additional element of control or domination resulting in antagonism.

Petitioner cites *Ashwander v. Tennessee Valley Authority* (1935), 297 U. S. 288, 80 L. Ed. 688, and *City of Indianapolis v. Chase National Bank*, 312 U. S. 62; 86 L. Ed. 48, and they illustrate the distinctions which must be made herein between diversity cases in general, and derivative suits in particular, for jurisdictional purposes, and the equitable requirements.

Ashwander was a derivative but not a diversity case, for jurisdiction there existed because the defendant was an agency of the Federal Government and a federal question concerning the power of that defendant was presented. There was, therefore, no necessity whatever to consider realignment on any ground or for any reason. The only issue in that case of any interest in the consideration of the present case was whether in equity the plaintiff was entitled to prosecute the suit. It was held that he was so entitled for two reasons, first, because the plaintiff was not merely challenging the right of the Board of Directors to exercise their business judgment and second, because

the managing Board had refused or failed to take action. In such a case, where federal jurisdiction existed on other grounds and no problem of realignment arose, the reasons for the failure or refusal of the Board to take action might be immaterial, but the reference to the business judgment rule appears to indicate the contrary. Only the right of a stockholder to seek equitable relief was involved and this required the two elements noted. It is with respect to this equitable right and not with respect to any jurisdictional question that this court made the statement quoted by petitioner on page 16 of his brief, and such statement is applicable only to a derivative action where no question of jurisdictional realignment was involved.

City of Indianapolis v. Chase National Bank was a diversity but not a derivative case. This decision is cited several times by petitioner. The decision was by a divided court in which there was an apparent divergence of views as to the facts. The prevailing opinion states that in a diversity case the parties should be aligned in accordance with the determination as to whether there was a collision of interests with respect to the primary matter in dispute. *Chase,* as the plaintiff, was trustee under a bond issue and not a shareholder of the gas corporation. It is clear from the opinion of the majority that *Chase* and its mortgagor, Indianapolis Gas Company, had cooperated prior to the bringing of the suit and that it was by agreement that *Chase* had instituted the suit. Had this been a derivative case, such action would have been collusive and such factor alone would have prevented maintenance of the action. The court in this case had no need to consider what has been called by this court the peculiar nature of derivative suits. (*Koster v. Lumbermens etc. Co.,* 330 U. S. 518 at 522.)

The equity procedural requirements which appear to be interjected, even when federal diversity jurisdiction is the only issue (*Cf. Doctor v. Harrington*), are presently laid down in Rule 23(b) of Federal Rules of Civil Procedure. This rule reflects the substance of former Rule 27 and the earlier Equity Rule 94 and, of course, this had followed the decision of this court in *Hawes v. Oakland*, 104 U. S. 450, 26 L. Ed. 827. Rule 23(b) establishes certain procedural requirements of the complaint, including averment of ownership of stock at the right time, a statement that the action is not collusive, and with particularity, the efforts of the plaintiff to secure the desired action from the directors and, if necessary, from the shareholders, or the reasons for failure.

The purpose and effect of the equity rule has been determined by this court: (a) as prescribing the manner in which jurisdiction otherwise existing shall be exercised; (b) as establishing a controversy which may be entertained by a court of equity; and (c) as designed to secure the federal courts from imposition upon their jurisdiction in such cases.

Venner v. Great Northern Railway Co., 209 U. S. 24, 52 L. Ed. 666;

Delaware & Hudson Company v. Albany & Susquehanna Railroad, 213 U. S. 435, 53 L. Ed. 862;

Koster v. (American) Lumbermens Mutual Casualty Co., 330 U. S. 518, 91 L. Ed. 1067;

Cohen v. Beneficial Industrial Loan Corp., 337 U. S. 541, 93 L. Ed. 1528.

The distinction between jurisdictional elements and compliance with the rule was sharply noted by this court in *Venner v. Great Northern Railway Co.*, 209 U. S. 24,

where the opinion actually divides the questions into two separate parts and separately discusses them. With respect to the Rule (Equity Rule 94) argument had been made that compliance was essential to jurisdiction, but this court specifically stated that the requirements of the Rule and the principles declared in *Hawes v. Oakland* did not raise the question of jurisdiction, but only prescribed the manner in which it shall be exercised, and that if jurisdiction does actually exist because of diversity but upon pleadings or proof, a case is not shown to fall within the Rule or the decisions, then it should be dismissed, not for lack of jurisdiction but on the merits for lack of equity. Failure of allegations or proof *in these respects* creates no defect of jurisdiction but only shows that the particular plaintiff had no right in himself to bring or maintain the suit and hence had no title to do so.

In *Doctor*, as already noted, it is said that the interests of the corporation were being "made" subservient to some illegal purpose. In *Koster* the same thought is expressed when it is said that the corporation "is disabled from protecting itself." In the cases which discuss the equitable requirements alone, the thought of disability is not indicated. Unwillingness to take action on the part of the directors is enough. This was the situation in *Ashwander v. T.V.A.*, 297 U. S. 288 and *supra*, where, since federal jurisdiction already existed, only the equitable requirements were concerned and it is in connection therewith that this court notes that the refusal of the directors might be for a number of reasons in the exercise of their judgment and still a cause of action might exist.

In contrast, in jurisdictional cases such statements are not made, and it is apparent that it is not merely unwillingness on the part of the Board but inability to act which

is the criterion. Clearly, if a Board is unable to act, barring a deadlock, such inability is due to some external factor. In the decisions considered, the corporation was unable to act or was alleged to be unable to act because it was so dominated and controlled that any action it might take would be merely the reflection of the will of the individuals in control and would not be the independent will of the Board. Identification of the corporation with the controlling individuals is, therefore, made and the corporation is aligned as a defendant because it and the individuals charged are really one party.

Petitioner here (Br. p. 22) urges that a fair evaluation, primarily of *Doctor* and *Venner*, would lead to the conclusion that the emphasis in those two cases upon domination and control referred only to the matter of procedural compliance with Equity Rule 94 and was not the basis for jurisdictional ruling. We submit that both cases were certified only on the question of jurisdiction and that, if there were any doubt as to the effect of *Doctor*, it is cleared up in *Venner*. Each case came up essentially on the complaint and the question in each case was simply whether the allegation of complete domination and control was sufficient to require the corporation to be retained as a defendant. Each case does mention the Equity Rule but *Venner* certainly distinguishes the effect of noncompliance with the Rule from any jurisdictional factor. *Delaware v. Susquehanna*, 213 U. S. 435 and *supra*, makes it perfectly clear that there was no impact of procedural compliance in *Doctor*. In *Delaware*, the Court of Appeals had thought that *Doctor* imputed a jurisdictional aspect to compliance with Rule 94, but this court rejected that imputation completely.

III.

The Fact That Warner Would Not Have Brought This Action and Resisted Plaintiff's Attempt to Maintain It in a Federal Court Does Not Require Warner to Remain Aligned as a Defendant.

As his second point herein (Pet. Br. p. 22), petitioner reargues in summary form the contentions previously made and relies upon the same cases, with particular emphasis upon *Indianapolis v. Chase National Bank,* 314 U. S. 62, 86 L. Ed. 48. He urges that Warner is antagonistic to the suit and does not want the Warner-United relationship to be disturbed. In effect, he urges that Warner should not be realigned because "what the complainant wants, Warner and its codefendants do not want." (Pet. Br. p. 24.) His view assumes that any manifestation by the corporation that it is not supporting his side of the claim as he alleged it, must result in alignment of the corporation as a defendant. Even the premise of petitioner's view disregards the fact that what he does and can want is shown by his complaint and is limited by law.

In his complaint, as previously noted, he asserted that the contract was forced upon the corporation as a result of control, domination, and conspiracy. The necessary implication is that the contract would not have been entered into by the corporation in its best interests if it had not been so forced to enter the relationship. The controversy necessarily concerns the question of whether the corporation was forced to make this contract, because plaintiff is not entitled to litigate a disagreement as to what are the best interests of the corporation, nor does such disagreement place the corporation in "antagonistic hands." Essentially the same reasons were alleged to excuse the making of a demand [R. pp. 11, par. 24], but it was found

that control or domination did not exist at *any* time [R. p. 75].

Rule 23(b) is procedural and requires, among other things, a disclosure to the court that the plaintiff has endeavored to obtain his remedy through the corporation itself (*Cohen v. Beneficial Industrial Loan Corp.*, 337 U. S. 541 at 556, 93 L. Ed. 1528 at 1541). The rule requires a statement of the reasons for failure but does not indicate what reasons may be acceptable. This must be determined from the substantive law.

It is established that a stockholder cannot bring a derivative action merely because of a difference of opionion with the Board of Directors as to the advisability of any act or action taken within the business judgment, discretion and power of the Board of Directors. We eliminate from discussion the possible grounds of *ultra vires*, violation of statute and similar things because they are not here involved in any way. This rule, applied in derivative cases and commonly known as the business judgment rule, is recognized as a matter of substantive federal equity in *Ashwander v. Tennessee Valley Authority*, 297 U. S. 288, 80 L. Ed. 688, where it was specifically held that one reason why the plaintiff had a right to proceed was because he was not merely challenging the right of the Board of Directors to exercise its business judgment.

Under *Erie v. Tompkins*, 304 U. S. 64, 82 L. Ed. 1188, and subsequent cases, the substantive law of the state is administered in diversity cases by the federal courts, though federal procedural rules apply. Reference to the substantive law of California will, therefore, assist in determining what "the complainant wants" by estab-

lishing what he can want. It is not here suggested that the substantive law of California will directly control federal jurisdiction but it is submitted that, through analysis of what must be in substance the cause of action under state law, the actual controversy in this case may be determined and alignment made accordingly.

The business judgment rule is the law of California, and in *Fornaseri v. Cosmosart Realty Corp.*, 96 Cal. App. 549, 274 Pac. 597, the rule is stated (p. 557) as follows:

> "In the absence of fraud, breach of trust or transactions which are *ultra vires,* the conduct of directors in the management of the affairs of a corporation is not subject to attack by minority stockholders by a suit at equity, where such acts are discretionary and are performed in good faith, reasonably believing them to be for the best interests of the corporation."

The facts of the present case fall within such statement of the rule with complete precision.

California applies the rule to the question of bringing an action, as well as to the act of which complaint is made, and applies it to both foreign and domestic corporations. In *Findley v. Garrett,* 109 Cal. App. 2d, 166, 240 P. 2d 421, the corporation involved was a Delaware corporation as is Warner. The court there said (p. 178):

> "The Board exercised its business judgment. Under such circumstances a stockholder may not usurp the discretionary powers of the managers of the corporation by commencing a derivative action. If, under such circumstances, the court should entertain such an action, it would be substituting its own business judgment for that of the directors. The determination of the matter by the board of directors is a bar to the action herein."

Furthermore, in considering derivative cases and their peculiar nature, the California courts accept and recognize domination and control as the element constituting disability. *Whitten v. Dabney,* 171 Cal. 621; 154 Pac. 312, came up on general demurrer for absence of facts and as barred by the Statute of Limitations. The court, dealing with the allegations, said (p. 629) that:

> "So long as the corporation itself remains under disability and is powerless to act by virtue of the fact that its control is in the hands of its Board of Directors accused of participation in the frauds, the Statute of Limitations does not run against it."

See also *Reid v. Robinson* (1923), 64 Cal. App. 46, 220 Pac. 676.

Reason supports the rule, for certainly the cause of action is that of the corporation and no stockholder could sue unless there was, at the time, a cause of action which could be enforced by his corporation, if it so desired. A corporation would have no cause of action itself, with respect to a contract, unless something were legally wrong with the contract itself by normal standards, such as fraud or lack of consideration, or unless something was wrong with the capacity of the contracting parties, such as disability. In *Smith v. Lewis,* 211 Cal. 294, 295 Pac. 37, it was held, for instance, that a stockholder could not bring action because the corporation itself was not permitted to bring action since it had failed to pay its franchise tax.

Here, the terms of the contract already referred to showed ample consideration and other necessary requireto be valid as a contract. The plaintiff's attack is based upon the capacity of the corporation in that the making of

the contract was not its own true act but was brought about through control exercised as a result of conspiracy. These respondents denied those allegations and such denials thereby raised the jurisdictional issue [R. pp. 21-22]. The facts proved at the trial were contrary to the allegations of the complaint and it was so found. The facts so found showed that there was no cause of action, and in a state court the action would have been dismissed for that reason, because of the applicability of the business judgment rule. In the Federal Court, with jurisdiction based solely on diversity, that ruling and disposition could not be made unless jurisdiction existed.

These matters, as indicated, go to the merits of the case, but, at least in this particular case, the facts going to the merits of the case are also the criteria from which to determine and isolate the controversy for the purpose of federal jurisdictional alignment. It is submitted that, since substantively, the plaintiff cannot complain merely of an unprofitable or improvident contract, then the controversy cannot be the wisdom or merits of that contract. The determination for the purposes of alignment of the parties, with respect to the true controversy, is dependent upon whether the contract was forced upon the Board of Directors so that its discretion was not truly exercised.

When such a case as the present one is brought in a Federal Court, the question of jurisdiction immediately arises. Controversy between the parties as to the existence of jurisdiction cannot itself be a guide in alignment because jurisdiction may not be conferred by agreement or acquiescence of the parties and it is, therefore, quite immaterial what the attitude or arguments of any of the parties may be with respect to the precise question which

determines jurisdiction. As the Court of Appeals in the present case said [R. p. 671; 237 F. 2d 321]:

> "Either jurisdiction subsists or its does not. There is absolute dichotomy."

Here it is submitted that the only substantive controversy is whether the corporation actually exercised its own will and discretion. As to that controversy, Warner did not and does not agree with the plaintiff, but the determination of that controversy here decides jurisdictional alignment. We submit that whether or not the parties agree or disagree or take opposite positions with respect to the facts which determine jurisdiction is beside the point. In the present case, the same facts determine both the existence of a cause of action and jurisdictional alignment, though these are quite separate questions. Here, there was a trial and those facts were determined. The assertions of domination and control, fraud and other impropriety being found by the trial court to be untrue, there could only be the question as to whether the actual contract had been made in the best interests of the corporation, and that question cannot be litigated by a stockholder under California law or under federal law. Certainly a question which cannot be litigated cannot be the question constituting the controversy for the purposes of diversity alignment.

If a corporation is controlled and dominated by the individual codefendants, it is clear that a united defense or the action is a consistent consequence of that control. Such control by the individuals benefiting is the cause, antagonism to the interests of the corporation is the result, and the joint defense is merely one of the almost inevitable effects. However, if there is no control, as the

trial court found to be the situation here, and the Board of Directors, in its independent judgment and believing that the claim that the corporation has been victimized is false, still elects to controvert the claim as alleged and refuses to admit the allegations by silence, then the corporate action is certainly not antagonistic to its own interests, but is a determination as to what are its own best interests by the only body entitled to make that determination.

Petitioner in this section of his brief relies heavily on *Indianapolis v. Chase National Bank,* 314 U. S. 62, 86 L. Ed. 48. This case has previously been discussed herein as a diversity and not a derivative suit. It was concerned only with the general diversity rule and not with the specific problems of a derivative case. Therein the court isolated the controversy as the question whether the assignee of a lease would be bound by its terms. The assignee had declined to be so bound. The basic dispute was between the lessor and the assignee of a lessee on a question of law. In the present case, the contract in itself presents no question of law but, on the contrary, the only question is one of fact as to whether that contract had been forced upon Warner. In the cited case, *Chase* was trustee under a bond issue secured by the assets of the lessor and its interest lay in protecting that security. This court ordered realignment with consequent failure of jurisdiction, since it regarded both the trustee and the mortgagor-lessor as having the same interest. As a matter of fact, the trustee and the lessor had agreed upon the bringing of the suit by the trustee in advance. The case illustrates the necessity for determining what the complainant and any named defendant really want. It has been pointed out herein, as a matter of substantive

law, what the complainant in the present case must want, irrespective of what he says. The cited decision is only favorable to the petitioner here, if his own analysis of what he wants, as expressed in his brief, is accepted as a fact and in disregard of the allegations of his complaint and of substantive law.

Nor is the jurisdictional conclusion here a sacrifice of jurisdictional integrity nor a deprivation of plaintiff's rights, if he has any, upon technical grounds. Neither party could in any way benefit by a judgment on the merits from a court which lacked jurisdiction. Such a judgment would be a nullity and subject to collateral attack at any time. State courts have unquestioned jurisdiction of this class of case and, unless the jurisdiction of a Federal Court is beyond question in the particular case, the litigation should be restricted to the other forum.

Conclusion.

On the basis of the series of decisions by this court and because of the substantive realities, it is respectfully submitted that the judgment of the Court of Appeals, affirming the judgment of the District Court that it lacked jurisdiction, should be affirmed.

Respectfully submitted,

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APPENDIX.

A. Supreme Court Rules. Rule 40(d)(2):

The phrasing of the questions presented need not be indentical with that set forth in the jurisdictional statement or the petition for certiorari, but the brief may not raise additional questions or change the substance of the questions already presented in those documents. Questions not presented according to this paragraph will be disregarded, save as the court, at its option, may notice a plain error not presented.

B. Federal Rules of Civil Procedure. Rule 17(a):

Real party in Interest. Every action shall be prosecuted in the name of the real party in interest; but an executor, administrator, guardian, trustee of an express trust, a party with whom or in whose name a contract has been made for the benefit of another, or a party authorized by statute may sue in his own name without joining with him the party for whose benefit the action is brought; and when a statute of the United States so provides, an action for the use or benefit of another shall be brought in the name of the United States.

C. Federal Rules of Civil Procedure. Rule 42(b):

Separate Trials. The court in furtherance of convenience or to avoid prejudice may order a separate trial of any claim, crossclaim, counterclaim, or third-party claim, or of any separate issue or of any number of claims, cross-claims, counterclaims, third-party claims, or issues.

D. Former Equity Rule 94, 104 U. S. IX:

Every bill brought by one or more stockholders in a corporation against the corporation and other parties, formed upon rights which may properly be asserted by the corporation, must be verified by oath, and must contain an allegation that the plaintiff was a shareholder at the time of the transaction of which he complains, or that his share had devolved on him since by operation of law, and that the suit is not a collusive one to confer on a court of the United States jurisdiction of a case of which it would not otherwise have cognizance. It must also set forth with particularity the efforts of the plaintiff to secure such action as he desires on the part of the managing directors or trustees, and, if necessary, of the shareholders. and the causes of his failure to obtain such action.